

UNITED STATES SENATE

Committee On Governmental Affairs

Subcommittee on Civil Service, Post Office, and General Services

Paper for Policy Forum on April 17, 1984:

"OPTIONS: COORDINATING PENSIONS WITH SOCIAL SECURITY"

THE OFFSET INTEGRATION APPROACH FOR DEFINED BENEFIT PENSION PLANS

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WHAT IS INTEGRATION?

These forums have been set up to discuss what changes should be made to the pensions of new federal employees now that they are covered under Social Security. This, the subject of my presentation today is very much at the heart of the matter. I'll be addressing the simplest of the current integration practices -- that of offsetting all or part of the Social Security benefit from the pension benefit that another plan provides. The theory of integration is fairly simple. It seeks to coordinate Social Security and other plan benefits so that, in total, they provide for a reasonable level of retirement income. This reasonable level is usually computed as a percentage of pre-retirement income. Thus integration allows for:

- (1) The level of retirement income (excluding personal savings) to be accurately planned for by the plan sponsor.
- (2) The tilt in the Social Security benefit towards the lower-paid to be compensated for so that equitable benefits are provided at all pay levels.

This presentation will explore the various integration approaches with emphasis on the offset method for defined benefit pension plans. Alternative integration approaches will be compared and contrasted, along with some discussion of other types of plans and the level of plan benefits.

CURRENT INTEGRATION PRACTICE - CORPORATE PLANS

Defined benefit plans, as the name implies, are pension plans in which the benefit at retirement is specified in some sort of formula. It is the responsibility of the plan sponsor to see that sufficient funds are available to pay for the promised retirement benefits.

Virtually all defined benefit pension plans are either directly integrated with Social Security or are implicitly integrated since benefits are lower than they might be in the absence of Social Security.

(1) The following is a brief description of the commonly used integration approaches:

- (a) Offset - This method subtracts an amount equal to some percentage of either the actual or, more commonly, the estimated Primary Social Security benefit from the gross plan formula benefit. This offset is generally pro-rated for short service employees. This is the most direct method of integration since the Social Security benefit appears explicitly in the formula. This method could produce low or even no benefits for participants at very low pay levels where the offset approaches the gross plan formula benefit.
- (b) Step-up/Excess - Under a step-up plan, benefits relate to compensation, with the benefit rate stepping-up for pay over the integration level. The integration level is related to the maximum taxable wage base for Social Security taxes. For instance, the benefit formula for a career employee might be 30% of pay up to the maximum taxable wage base for Social Security taxes plus 50% of pay in excess of such wage base. An excess plan is a special case of the step-up where the plan provides benefits only on pay over the integration level. These methods integrate in a less direct manner than the offset since the Social Security benefit never appears explicitly in the plan formula. Also, at least in the case of the step-up method, all participants will earn some benefits under the plan.
- (c) Cap - The gross plan formula benefit plus the Primary Social Security benefit is limited to some percentage of final or final average pay. This approach bears some similarities to the offset. Many plans use the cap as a maximum limit on plan benefits that are already integrated under another method.
- (d) Implicit - The level of gross plan formula benefits is lower for all participants than it would be in the absence of a Social Security program. Implicit integration is commonly found in plans that cover participants who earn similar salaries (for example, certain union plans). Integrating by simply lowering the otherwise available benefit level is especially appropriate in that situation since the Social Security benefits will be very similar for all such participants.

Currently, based on surveys of large corporate pension plans covering salaried employees, about 60% integrate by using an offset, 30% use a step-up or excess type of formula, and the remaining 10% either use a cap or are not explicitly integrated. (See Corporate Pension Plan Study - A Guide for the 80's by Banker's Life or other similar surveys

of pension plans for details). As discussed above, the explicit integration percentages will be lower for plans covering primarily union employees. It is also widely held, though little data is available, that integration is much less prevalent among smaller plans.

(2) Legal requirements on maximum integration levels for qualified plans

Under current regulations, the maximum allowable offset for a private qualified defined benefit plan is 83-1/3% of the Primary Social Security benefit. The 83-1/3% maximum limit is derived by taking credit for the "employer's 50% share" of the Social Security benefit, adjusted for the value of ancillary Social Security benefits. (Using a similar approach, maximum integration limits are derived for step-up and excess plans.)

However, the 83-1/3% maximum offset is only applicable to a bare bones pension plan. Adjustments to the offset percentage are required for disability and survivor benefits and subsidized early retirement benefits. Therefore, for most plans, the present rules only allow an offset in the 50-60% area. These limits and adjustments as currently used are embodied in Revenue Ruling 71-446, which was issued by the Internal Revenue Service in 1971.

(3) Problems in current integration practice

Current integration rules are overly complex, particularly in regard to the adjustments that must be made to the basic integration limits. Rather than getting overly involved in the present rules, I have attached a copy of a booklet, written by Theresa B. Stuchiner, a Partner at Kwasha Lipton, entitled "How to integrate a Retirement Plan with Social Security."

Also, even if the theoretical basis underlying the rules is valid, the actual limits and adjustments developed in 1971 were based on the Social Security law then in effect. Since then many significant changes have taken place, making the current rules somewhat outdated and obsolete.

Additionally, explicitly integrated pension plan formulas result in benefits that are more difficult to calculate for the plan administrator and more difficult to understand for the plan participant. Plan participants often feel that integration is a way of taking away benefits that they have earned. Therefore, in order to avoid such misconceptions and confusion as well as to communicate the benefit program clearly, it is important that the integration be as concise and clear as possible.

Finally, there is the problem of low or no plan benefits for short service or low paid participants as well as inequities in replacement rates that can result in over or under pensioning for some plan participants.

50% OFFSET PROPOSAL

A number of proposals designed to simplify the current integration rules have been devised. One of these, the "50% offset proposal", simply has a maximum integration limit of 50% for offset plans. This limit is based on the "50% employer's share" of the Social Security benefit. (Using the same approach analogous limits are derived for step-up and excess plans). The major advantage of this proposal is that very few, if any, adjustments to the integration limit are necessary.

(1) Compatibility with current corporate practice

The 50% offset proposal ties in nicely with current integration practice since offsets for most plans are in the 50-60% range. Also, the 50% offset limit does not need to be adjusted as Social Security benefits change in the future. The limit is tied only to the employer's share of the Social Security benefit.

(2) Few adjustments to the 50% offset are needed

The 50% offset proposal requires little adjustment for ancillary benefits. Disability benefits are handled by simply offsetting 50% of the disability Social Security benefits. Also, no adjustment is needed for most death benefits. A problem arises, however, if early retirement benefits are subsidized or payable prior to age 62 (the earliest age for commencement of Social Security benefits). In this case a number of simple alternatives are available under the 50% offset proposal. These adjustments effectively reduce the amount of the offset to take account of the richer plan benefits. While this approach ties in with current integration rules for qualified plans, it may be modified or eliminated for the purpose of the CSRS plan.

A problem with the 50% offset (as with any other integration proposal that complies with current law) is that the full tilt of Social Security benefits towards the lower paid cannot be compensated for. The only alternative which accomplishes that is a full offset of the Social Security benefit.

(3) A 100% offset may be more appropriate in the absence of legislative requirements since it offsets the full Social Security tilt

For the CSRS plan, it may be advantageous to approach Social Security integration from a different point of view. Instead of looking at the employer's share of the Social Security benefit as the appropriate limit, let's construct an integration method which attempts to provide equitable benefits at all pay levels considering Social Security and the plan benefit as a unit. This approach leads to a 100% offset of the Social Security benefit as being the appropriate integration method. This method is not allowable under current integration rules for private qualified plans, but in the absence of any legal restrictions for a

government plan, it may be preferable to a lesser offset percentage. By offsetting the full Social Security tilt towards the lower paid, fair benefits at all pay levels will be provided. This method is also easy to communicate to plan participants since the integration is explicit and simple, and is being utilized in order to provide equitable benefits for all plan participants.

COMPARING OTHER INTEGRATION METHODS TO OFFSET

- (1) The step-up/excess approach has several disadvantages relative to the offset:
 - (a) Having two different rates of benefit accrual results in a plan formula that is cumbersome and difficult to understand.
 - (b) The integration limit for determining which part of a participant's pay receives the higher accrual rate should be updated each year based on the new Social Security wage base. This results in a basic plan formula that changes from one year to the next. Alternatively, if the integration limit is not adjusted annually, the plan gradually becomes less and less integrated. This occurs because the pay levels of participants are generally rising while the integration limit remains level.
 - (c) The indirect nature of Social Security integration under this method obscures the impact of the Social Security benefit on the plan benefit. In fact, the Social Security benefit is not explicitly referred to in the formula.

One advantage of the step-up/excess approach is that the benefit is easier to calculate. The Social Security integration limit is constant for all plan participants each year as compared to the offset where the Social Security benefit varies for each individual.

Also, there is no perception of earned benefits being "taken away" as can occur with the offset since nothing is being subtracted out.

- (2) The cap approach is essentially the same as the offset for final average pay plans. For other types of plans the cap, if it is to be effective for most plan participants, would make the plan appear to be a final average pay plan. But a well designed integration method should not change the basic type of plan formula. On the other hand, if the cap is not effective for many plan participants, then the plan is not really integrated.
- (3) Either implicitly integrating or not integrating has the advantage of simplicity. Also, (as was mentioned above for step-up plans) nothing is being "taken away" from the plan formula. The obvious disadvantage is the fact that the Social Security tilt towards the lower paid is not being taken into account. Therefore, these types of plans, together with Social Security, will provide benefits that are relatively higher for lower paid participants.

The exception to this, as was discussed earlier, is a plan in which the participants are all earning about the same pay. In this situation, implicit integration will be the preferred method.

FORMAL 100% OFFSET PROPOSAL

In light of the foregoing discussion, let's formulate a specific integration approach so that we may examine the problems that can arise in more detail. Our method will be a 100% offset of the Social Security benefit, with no adjustments for ancillary benefits. Employee contributions will not be required on pay below the current Social Security wage limit. The offset will be based on the appropriate Social Security benefit for that type of retirement. For example, disability retirements will have the disability Social Security benefit offset. For early retirements before age 62, no offset will be applied until age 62. The offset will be pro-rated for employees with less than full career service (i.e., 30 years).

If any adjustments are to be made for early retirements, all retirements prior to the Social Security unreduced benefit commencement age should be considered as such. This is an important point to clarify in light of the recent amendments to the Social Security laws. Under the current law, the age for commencement of unreduced Social Security benefits will rise gradually from the current age of 65 to age 67.

The Social Security benefit itself will generally be estimated on the basis of tables prepared for that purpose. Alternatively, the benefit may be the actual benefit calculated by the Social Security Administration. The latter approach is more accurate, but also more costly from an administrative point of view. Under current Social Security law, the benefit is quite complicated to calculate.

PROBLEMS WITH 100% PROPOSAL

(1) Issue of minimum benefits

As was discussed previously, the topic of minimum benefits needs to be addressed in connection with Social Security integration. Since employee contributions will be required under the CSRS plan, it may be advantageous to have a plan where all participants get some benefits at retirement. Accordingly, a minimum benefit (perhaps in the form of some flat dollar amount per month for each year of service) should probably be a part of the plan design. It is important to note that these minimum benefits are not really a part of the integration method itself. They are needed, however, in order to ensure some level of plan benefits for all participants at retirement.

(2) Ease of understanding for employees and administrators

The beauty of the 100% offset approach is its simplicity. Although the estimation of the Social Security benefit and the resulting CSRS plan benefit under this approach are not simple to calculate

and understand, the benefits provided by the two sources taken together should be well defined (by the CSRS gross plan formula) and easy to communicate. Plan participants will be able to plan financially for retirement without having to know what benefits Social Security will provide. Further, they will not have to worry about potential decreases in Social Security benefits in the future as long as the CSRS plan is there.

- (3) Possible alternatives for problem situations (short service, relatively low-paid, etc.)

In spite of the proration of the offset described above, there are still some problems for short service participants. For many, the pro rata portion of the Social Security benefit will not be a fair indicator of the amount of the benefit attributable to service with the government.

In particular, for employees with erratic pay histories and gaps in their work record, the estimated Social Security benefit used in the benefit calculation will overstate of their actual Social Security benefit and will therefore understate their pension plan benefit. This problem may be solved by using the actual Social Security benefit, although there are a number of practical problems associated with this approach. The most effective approach to this problem as well as the problem, of low or no benefits for lower paid employees, might be to install minimum benefits.

DEFINED CONTRIBUTION PLANS

A defined contribution plan (e.g. savings plan) does not specify a benefit at retirement. The benefit is simply the equal to the amount of money in the participant's account. No benefit level is guaranteed. Therefore, a defined contribution plan is always fully funded. Currently, many corporations are making use of defined contribution plans in their retirement programs. Most of these plans are not integrated with Social Security -- that is, the contribution rates are the same at all pay levels. Due to the less stable and unpredictable nature of the defined contribution plan benefit, this type of plan is generally used to supplement a defined benefit pension plan. The defined benefit plan is generally integrated and forms the major part of the retirement income program. We anticipate that, if the CSRS retirement program incorporates a defined contribution plan, it will be used in a similar manner and therefore integration will probably not be an issue.

LEVEL OF PLAN BENEFITS

Finally, a few words should be said about the level of benefits to be provided by the combination of the CSRS plan and the Social Security benefit.

Generally, in the corporate world, a post retirement income objective is defined. The sources usually considered are (1) pension benefits, (2) Social Security, and (3) personal savings. A common objective is

to provide the same level of pre-retirement income to the full career participant after retirement at or after age 65 on a post-tax basis. This approach is probably advisable for the CSRS plan as well. Integrating the CSRS benefit fully with Social Security greatly simplifies the analysis of retirement income objectives and total benefits will be unaffected by future changes in the level of Social Security benefits. Of course if Social Security benefits were to decrease in the future, the slack would be made up by the CSRS pension plan and the cost of the plan would rise accordingly. Therefore, it is important to follow up the initial retirement income objective at reasonable intervals throughout the life of the plan so that the level of plan benefits may be re-evaluated in light of changing circumstances.